IT 04-1
Tax Type: Income Tax
Issue: Unitary Apportionment

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	**No. 01-IT-0** **FEIN: 00-0000000** **Tax yrs.: 1996, 1997, 1998**
v.	
ABC CO., **Taxpayer**	**Charles E. McClellan** **Administrative Law Judge**

RECOMMENDATION FOR DECISION

Appearances: Ralph Basset, Special Assistant Attorney General, for the Illinois Department of Revenue (the "Department"); Thomas F. Joyce, of Bell, Boyd & Lloyd, LLC. for ABC Company (the "Taxpayer").

Synopsis:

This matter arose from a timely filed protest to a Notice of Deficiency sent by the Department to the Taxpayer on September 5, 2001. There are two issues involved in this matter. The first issue is whether Deposit Type Funds are included with "direct premiums written" in the apportionment factors under Section 304(b)(1) of the Illinois Income Tax Act.[1] The second issue is whether the Taxpayer can use premiums net of reinsurance premiums paid to other affiliated insurance companies for purposes of the 80/20 test to determine if an affiliate, XYZ Insurance Co. ("XYZ") is includible in the Taxpayer's

[1] Unless otherwise noted, all statutory references are to 35 ILCS 5/101, *et seq*., the Illinois Income Tax Act ("IITA" or the "Act").

unitary business group under IITA § 1501(a)(27). The parties filed a Stipulation of Facts in which they stipulated to the relevant facts involved in this matter and to the genuineness of 32 exhibits.

I recommend that that the Deposit Type Funds be included in the numerator and denominator of the Taxpayer's apportionment factor for 1998 as reported by the Taxpayer. I recommend that the amount of premiums written, without reduction for reinsurance premiums ceded, be used for purposes of the 80/20 test to determine if XYZ is includible in the Taxpayer's unitary business group under IITA § 1501(a)(27).

Findings of Fact[2]:

1. The Taxpayer is a wholly owned subsidiary of ABC International Group, Inc., a publicly held corporation. Stip. ¶ 1.
2. The Taxpayer, with its affiliates, conducts a unitary insurance business throughout the United States and internationally. Stip. ¶ 2.
3. The Taxpayer's principal place of business is New York. Stip. ¶ 3.
4. Deposit Type Funds are funds reported on Schedule T, Column 6 (captioned "Deposit Type Funds") of the Annual Statement filed with the Illinois Department of Insurance for each year at issue. Stip. ¶ 4.
5. Deposit Type Funds are deposits and other amounts received for contracts without any mortality or morbidity risk. They include unallocated annuity contract deposits and deposits for guaranteed interest and similar contract forms. Stip. ¶ 5.
6. The Taxpayer included Deposit Type Funds in the computation of the premium apportionment factor on its Illinois Corporation Income and Replacement Tax

[2] The Findings of Fact are taken from the Stipulation of Facts submitted by the parties, and, for the most part, are direct quotations.

Returns for the years 1996, 1997, and 1998 that it filed on a calendar year basis. Stip. ¶ 6.

7. For the 1998 year, the Department reduced the numerator in the Taxpayer's premium apportionment factor by the amount of Illinois Deposit Type Funds, for XYZ Life Insurance Company reported on Schedule T, Line 14, Column 6 of the XYZ Life Insurance Company Annual Statement filed with the Illinois Department of Insurance. The total amount of the numerator reduction for 1998 was $15,930,349. Stip. ¶ 7, Exhibit 17.

8. For the 1998 year, the Department reduced the denominator in the Taxpayer's premium apportionment factor by the total amount of Deposit Type Funds for the three companies in the group plus other adjustments for each company in the group. The total amount of the denominator reduction for 1998 was $1,414,640,870. Stip. ¶ ¶ 8, 9.

9. The Department did not make similar adjustments to the Taxpayer's premium apportionment factor for 1996 or 1997. Stip. ¶ 11.

10. XYZ has a license to conduct the insurance business in Japan through a branch company. Stip. ¶ 12.

11. In the late 1970s, XYZ was incorporated with a branch office in Japan in order to preserve the market identity of XYZ Inc., a Japanese corporation operating as the managing general agent for the Taxpayer in Japan which was dissolved in the course of addressing compliance issues under Japanese law. Stip. ¶ 13.

12. The affiliates of XYZ ("XYZ Affiliates") involved in reinsurance arrangements with it during the years in question were ABC International Reinsurance

Company, Ltd., ABC International Underwriters Overseas, Ltd., ABC International Underwriters Overseas Association, New Insurance Company, and National Union Fire Insurance Company. Stip. ¶ 14.

13. The XYZ Affiliates were wholly owned subsidiaries of ABC International Group, Inc. Stip. ¶ 15.

14. XYZ and the XYZ Affiliates entered into reinsurance contracts entitled the *Casualty Quota Share Treaty* (Exhibit 30) and the *Marine Quota Share Treaty* (Exhibit 31) that were in effect during 1996, 1997, and 1998. Stip. ¶¶ 16, 17.

15. Under the reinsurance contracts between XYZ and the XYZ Affiliates, a specified percentage of XYZ's insurance liability was automatically, and without further action, allocated to the XYZ Affiliates as reinsurers. Stip. ¶ 18.

16. Under the reinsurance contracts XYZ was entitled to a commission on the net premiums ceded, as set forth in ARTICLE VIII of the *Casualty Quota Share Treaty* and ARTICLE VIII of the *Marine Quota Share Treaty*. Stip. ¶ 19.

17. The amounts entered for "Reinsurance Premiums Ceded" entered in Column 1 of Schedule F-Part 3 of the Annual Statement filed with the Illinois Department of Insurance for each year represent gross premiums ceded. The amounts are not reduced by commissions paid on the ceded premiums. Stip. ¶ 20, Exhibits 11, 12, and 13.

18. XYZ remained ultimately liable for all of the insurance ceded under the reinsurance contracts. Stip. ¶ 21.

Conclusions of Law:

Factual Background and Issues

The Taxpayer is a wholly owned subsidiary of ABC International Group, Inc., a publicly held corporation. The Taxpayer, with its affiliates operates a unitary insurance business throughout the United States and internationally. The Taxpayer's principal place of business is in New York City. For the years at issue, the Taxpayer filed its Illinois income tax returns on a combined basis with its affiliates that comprised a unitary business group.

There are two issues involved in this case. The first issue is whether Deposit Type Funds should be included in the numerator and the denominator of the Taxpayer's apportionment formula factor for 1998. The second issue is whether the Taxpayer should use premiums net of reinsurance premiums paid to other affiliated insurance companies for purposes of determining whether 80% or more of the business of XYZ is conducted outside the United States, in which case it would not be includible in the Taxpayer's unitary business group.

Legal Background

The overlying taxation scheme for corporations that gave rise to the issues involved in this case is set forth in the IITA and is described as follows:

> Under the Illinois Income Tax Act, a tax measured by *net income* is imposed on every corporation for each taxable year ending after July 31, 1969, on the privilege of earning or receiving income in or as a resident of this State. (Ill.Rev.Stat.1979, ch. 120, par. 2-201(a) [now 35 ILCS 5/201(a)] Net income is that portion of the taxpayer's *base income* for such taxable year which is allocable to this State less the standard allowable exemption. (Ill.Rev.Stat.1979, ch. 120, par. 2-202(a) [now 35 ILCS 5/202(a)] A corporation's base income is equal to the taxpayer's *taxable income* for the taxable year for Federal income tax purposes, subject to certain adjustments not directly

> relevant here. (Ill.Rev.Stat.1979, ch. 120, par. 2-203(b)(1), (2) [now 35 ILCS 5/203(b)(1), (2)] *Taxable income* is defined by the Act [35 ILCS 5/203(e)(1)] as "taxable income properly reportable for federal income tax purposes for the taxable year under the provisions of the Internal Revenue Code." *Searle Pharmaceuticals, Inc. v. Department of Revenue*, 117 Ill.2d 454, 458; 512 N.E.2d 1240 (1987) (italics in the original)

Apportionment Factor Issue

The base income, other than nonbusiness income, of a corporation that operates in Illinois and one or more other states is apportioned to Illinois by an apportionment formula set forth in the statute. The apportionment formula for insurance companies is the ratio of the premiums written for property or risks in Illinois to the premiums for property or risks everywhere expressed as a percentage. Specifically, the statute provides as follows:

> Except as otherwise provided by paragraph (2), business income of an insurance company for a taxable year shall be apportioned to this State by multiplying such income by a fraction, the numerator of which is the direct premiums written for insurance upon property or risk in this State, and the denominator of which is the direct premiums written for insurance upon property or risk everywhere. For purposes of this subsection, the term "direct premiums written" means the total amount of direct premiums written, assessments and annuity considerations as reported for the taxable year on the annual statement filed by the company with the Illinois Director of Insurance in the form approved by the National Convention of Insurance Commissioners or such other form as may be prescribed in lieu thereof. 35 ILCS 5/304(b)(1)

For each of the years 1996, 1997, and 1998, the Taxpayer included Deposit Type Funds in the numerator and the denominator of its apportionment factor. Deposit Type Funds are deposits and other amounts received for contracts without any mortality or morbidity risk. They include unallocated annuity contract deposits and deposits for

guaranteed interest and similar contract forms. Deposit Type Funds were reported by Taxpayer on Schedule T, Column 6 of the Annual Statement filed with the Illinois Department of Insurance for each year at issue.

For the 1998 year, but not the 1996 or 1997 years, the Department adjusted Taxpayer's apportionment formula by eliminating the Deposit Type Funds from the numerator and the denominator of Taxpayer's apportionment factor. The issue to be addressed is whether Deposit Type Funds are properly includible in the "direct premiums written" amount in the apportionment factors under Section 304(b)(1) of the Illinois Income Tax Act.

The Taxpayer argues that the inclusion of the Deposit Type Funds in the numerator and denominator of the Taxpayer's apportionment factor is consistent with the statute and with the historical position of the Department. I agree with the taxpayer that the statute requires the inclusion of the Deposit Type Funds in the factor.

The statute states that "direct premiums written" are includible in the numerator and the denominator of the apportionment factor. 35 ILCS 5/304(b)(1) The statute defines the phrase "direct premiums written" to be "the total amount of direct premiums written, **assessments and annuity considerations** as reported for the taxable year on the annual statement filed by the company with the Illinois Director of Insurance in the form approved by the National Convention of Insurance Commissioners or such other form as may be prescribed in lieu thereof." (emphasis added) *Id.*

The Department argues that the phrase “direct premiums written” is limited to direct premiums written for insurance upon property or risk because that is what the legislature intended.

In a situation, such as this, involving statutory construction and the determination of legislative intent, "[T]he cardinal rule of statutory construction is to ascertain and give effect to the true intent of the legislature. The best evidence of legislative intent is the language used in the statute itself, which must be given its plain and ordinary meaning. The statute should be evaluated as a whole, with each provision construed in connection with every other section. If legislative intent can be ascertained from the statute's plain language, that intent must prevail without resort to other interpretive aids." *Schawk, Inc. v. Zehnder,* 326 Ill.App.3d 752, 755; 761 N.E.2d 192, 194 (1st Dist. 2001) (quoting *Paris v. Feder* 179 Ill.2d 173, 688 N.E.2d 137 (1997)).

Applying the aforementioned rule of statutory construction, the language of the statute makes it clear that the legislature intended that the Deposit Type Funds are to be included in the Taxpayer’s apportionment factor. The statute specifies that “direct premiums written” is not limited to premiums written for insurance upon property, or risk as advanced by the Department. Rather, the phrase means “the total amount of direct premiums written, **assessments and annuity considerations** as reported for the taxable year on the annual statement filed by the company with the Illinois Director of Insurance in the form approved by the National Convention of Insurance Commissioners.” (emphasis added) 35 ILCS 5/304(b)(1). The Deposit Type Funds reported by the Taxpayer on Schedule T, Column 6 of the Annual Statement it files with the Illinois Department of Insurance are the assessment and annuity considerations referred to in the

statute.

This interpretation is supported by language in the Illinois Life and Health Insurance Guaranty Association Law (the "Insurance Law"). That statute defines "annuity contracts and certificates", for which the premiums at issue are received by the Taxpayer, as follows:

> "Annuity contracts and certificates under group annuity contracts include but are not limited to guarantee investment contracts, deposit administration contracts, unallocated funding agreements, allocated funding agreements, structured settlement agreements, lottery contracts and immediate or deferred annuity contracts." 215 ILCS 5/531.03(2)(a).

This similarity between the language in the Insurance Law and in the apportionment formula in the IITA, as with the reference in the IITA to the annual reporting required under the Insurance Law, demonstrates that the legislature intended the IITA to be consistent with the Insurance Law. Therefore, the assessments and annuity considerations that the taxpayer reported on Schedule T, Column 6 of the Annual Statements it filed with the Illinois Department of Insurance are properly includible in the taxpayer's apportionment factor because they fall within the definition of the phrase "direct premiums written" in the statute. Thus, the Department's argument that the statute excludes the Deposit Type Funds is incorrect.

In discussing the inconsistency found in the instant audit, wherein the Deposit Type Funds were allowed into the apportionment factor for 1996 and 1997, but removed by the Department for 1998, the Department argues that its interpretation of the apportionment formula language prior to 1998 was incorrect. This argument is without merit. The apportionment factor instructions for 1996 and 1997 were consistent with the

language of the statute. While the Department can change its interpretation of statutory language, in this case, the change in the apportionment instructions for insurance companies for 1998 was inconsistent with the plain language of the statute.

The Taxpayer has presented additional arguments regarding the changed instructions. However, I need not address those arguments because I have concluded that the Department's reinterpretation of the statute for 1998 was incorrect as a matter of law.

The Taxpayer also argues, in the alternative, that it is entitled to alternative apportionment under IITA § 304(f). However, since I have concluded that the Department's change in its interpretation of the statute for the 1998 year was incorrect as a matter of law, I need not address the IITA § 304(f) argument requesting alternative apportionment.

The "80/20" Test Issue

XYZ, a wholly owned subsidiary of Taxpayer's parent corporation, is an affiliate of the Taxpayer. During the years at issue, XYZ was involved in reinsurance arrangements with the XYZ Affiliates. Under the reinsurance contracts between XYZ and the XYZ Affiliates, a specified percentage of XYZ's insurance liability was automatically, and without further action, allocated to the XYZ Affiliates as reinsurers. Under these reinsurance contracts, XYZ was entitled to a commission on the net premiums ceded. The amounts ceded represent gross premiums ceded, without being reduced by commissions paid to XYZ. XYZ remained ultimately liable for all the insurance ceded under the reinsurance contracts.

In general terms, a group of corporations will constitute a unitary business group if they are related through common ownership and comprise a unitary business

enterprise. Specifically, insofar as it relates to the 80/20 issue in this case, the term "unitary business group" is defined in the statute as follows:

> The term "unitary business group" means a group of persons related through common ownership whose business activities are integrated with, dependent upon and contribute to each other . . . ..
> 35 ILCS 5/1501(a)(27)

The statute contains an exception in the case of a group of companies, some of which conduct their operations outside of the United States. That section of the statute provides as follows:

> The group will not include those members whose business activity outside the United States is 80% or more of any such member's total business activity; for purposes of this paragraph and clause (a) (3) (B) (ii) of Section 304, business activity within the United States shall be measured by means of the factors ordinarily applicable under subsections (a), (b), (c), (d), or (h) of Section 304. *Id.*

The issue in this case is whether the Taxpayer should use premiums net of reinsurance premiums paid to other affiliated insurance companies for purposes of the 80% test set forth in IITA § 1501(a)(27) to determine if XYZ is includible in the Taxpayer's unitary business group as the Taxpayer asserts, or whether it should use gross premium amounts as the Department asserts.

IITA § 304(b)(1), quoted above, provides the single factor apportionment formula based on premiums written for insurance companies. Because of the reference to IITA § 304(b) in IITA §1501(a)(27), the definition of "net premiums written" as set forth in IITA § 304(b)(1) also applies to the calculation of the 80% test. IITA § 304(b)(1) defines the term "net premiums written" to be "the total amount of direct premiums written, assessments and annuity considerations as reported for the taxable year on the annual

statement filed by the company with the Illinois Director of Insurance in the form approved by the National Convention of Insurance Commissioners or such other form as may be prescribed in lieu thereof." Neither IITA § 1501(a)(27) nor IITA § 304(b)(1) provide for any offset or reduction of the total amount for reinsurance premiums.

In construing the language of a statute, the language of the statute, without more, generally provides the best evidence of the legislature's intent. *Board of Education of Rockford School District No. 205 v. Illinois Educational Labor Relations Board*, 165 Ill. 2d 80, 87 (1995). Where the statutory language is clear and unambiguous, the plain and ordinary meaning of the words will be given effect without resorting to extrinsic aids for construction. *Id.* The statute setting forth the 80% test, IITA § 1501(a)(27), uses the phrase "total business activity" and references the apportionment factors in IITA § 304 as the numbers to be used in the test. IITA § 304(b)(1) uses the phrase "total amount of net premiums written". Had the legislature intended that gross premiums net of reinsurance premiums should be used for the 80% test, it could have said so in the IITA section prescribing the 80% test. The plain language of the statute makes it clear that the amount of premiums to be used in determining whether 80% or more of a taxpayer's business activity is conducted outside the U.S. in making the 80% test calculation is the total amount without reduction for the reinsurance premiums ceded.

The Department's regulation clarifying the meaning of the phrase "unitary business group" in IITA § 1501(a)(27) explains the statutory language by providing, in relevant part, that, "The factors to be used in determining whether 80% or more of a person's business activity is conducted outside the United States shall be gross figures without eliminations premised on the person's membership in any unitary business

group." 86 IL. Admin. Code § 100.9700(c). There is no question, based on the statute and the Department's regulations, that the amount of premiums taken into account for the 80% test should not be net of the reinsurance premiums ceded.

The Taxpayer asserts that the Department attempted to rewrite the statute in publishing its regulation. This argument is incorrect. "Administrative rules can neither limit nor enlarge the scope of a statute." *Canteen Corp. v. Dept. of Rev.,* 123 Ill 2d 95, 108; 525 N.E.2d 73, 78 (1988) This regulation neither expands nor limits the language of the statute. The statute prescribing the 80% test adopts the definition of the term "direct premiums written" set forth in IITA § 304(b)(1). It does not allow reduction for ceded reinsurance premiums. The language in the regulation is consistent with the language in the Section 304(b)(1) definition of the phrase "direct premiums written" which states that the phrase means "the **total** amount of direct premiums written, etc." The use of the word "total" makes it clear that the amount of premiums is not to be reduced by reinsurance premiums ceded. The regulation explains that the statute requires the gross amount of the premiums to be used in the 80% test. The regulation does not expand the statutory language, and, therefore, it is valid.

The Taxpayer also argues that because the term "insurance premiums" is not defined in the IITA, reference must be made to the Internal Revenue Code ("IRC"), citing IITA § 102, 35 ILCS 5/102. That section of the IITA provides as follows:

> Except as otherwise expressly provided or clearly appearing from the context, any term used in this Act shall have the same meaning as when used in a comparable context in the United States Internal Revenue Code of 1954 or any successor law or laws relating to federal income taxes and other provisions of the statutes of the United States relating to federal income taxes as such Code, laws

> and statutes are in effect for the taxable year. 35 ILCS 5/102.

The Taxpayer argues that the closest analog to the term "insurance premiums" in the IITA is the term "premiums earned" in the IRC. The term "premiums earned" is defined in IRC § 832(b)(4)(A) to mean "gross premiums written on insurance contracts during the taxable year less returned premiums paid for reinsurance". The Taxpayer concludes that this language requires that the insurance premiums taken into account in the 80% test must be net of reinsurance premiums.

The term "premiums earned" in the IRC is not the same as the term "direct premiums written" in the IITA. The language in the statute setting forth the 80% test, 35 ILCS 5/1501(a)(27), does not use the term "insurance premiums". It refers to the apportionment factors set forth in IITA § 304 for determination of the factors to use in the 80% test. The term "direct premiums written" is defined in IITA § 304(b)(1), so reference to the IRC as provided IITA § 102 is neither necessary nor required to determine its meaning.

Furthermore, the IITA § 304(b)(1) definition of "direct premiums written" adopted in IITA §1501(a)(27) for purposes of the 80% test is not used in a context similar to the use of the definition of "premiums earned" in IRC § 832. The phrase "premiums earned" is given its own definition in the IRC. The context in which the term "direct premiums written" is used in the IITA 80% test to determine if a corporation is member of a unitary business group is far different from the use of the term "premiums earned" in the IRC, where it is defined for the purpose of calculating federal taxable income. The Taxpayer's analogy to the IRC is incorrect.

The Taxpayer also argues that the Department's use of gross premiums instead of premiums net of reinsurance premiums would produce arbitrary, unpredictable, and inconsistent results from year to year. The Taxpayer has presented hypothetical calculations that purport to show that under the Department's interpretation of the statute, XYZ would be includible in the unitary group in some years but not others depending upon the amount of insurance ceded to the reinsurance companies. Although that might be the case, the language of the statute makes it clear that the amount of premiums taken into account for the 80% test should not be net of the reinsurance premiums for ceded insurance. Furthermore, whether 80% of XYZ's business is over or under the 80% calculation could change from year to year, under either the Department's construction or the Taxpayer's construction depending on the amount of insurance written and ceded from year to year. Therefore, Taxpayer's argument based on predictability, or lack thereof, is not supported by the record.

For the reasons set forth above, I recommend as follows:

1. The Deposit Type Funds should be included in the numerator and the denominator of the Taxpayer's apportionment formula factor for 1998.
2. The Taxpayer's direct premiums written without reduction for the reinsurance premiums should be used for the 80% test.
3. The Notice of Deficiency should be adjusted accordingly; and, as so adjusted, it should be made final.

Date: 12/5/2003

Charles E. McClellan
Administrative Law Judge